VZCZCXYZ0017
PP RUEHWEB

DE RUEHQT #0129/01 0421850
ZNY CCCCC ZZH
P 111850Z FEB 08
FM AMEMBASSY QUITO
TO RUEHC/SECSTATE WASHDC PRIORITY 8443
INFO RUEHBO/AMEMBASSY BOGOTA 7309
RUEHCV/AMEMBASSY CARACAS 2861
RUEHLP/AMEMBASSY LA PAZ FEB LIMA 2351
RUEHGL/AMCONSUL GUAYAQUIL 3263

C O N F I D E N T I A L QUITO 000129

SIPDIS

SIPDIS

E.O. 12958: DECL: 02/11/2018
TAGS: ECON EINV EFIN ETRD PGOV EC
SUBJECT: ECUADORIAN ECONOMIC POLICIES IN 2007: MIX OF
RHETORIC, PRAGMATISM AND UNCERTAINTY

Classified By: Classified by Ambassador Linda Jewell. Reason: 1.4 B a
nd D.

¶1. (C) Summary. In Correa's first year in office, there was occasionally fiery rhetoric on economic policy, but in practice the GOE implemented a limited number of policy changes, which were mostly pragmatic. U.S. investors shared this experience, where their treatment was more moderate than the rhetoric would suggest. The GOE approach was uneven as the Correa government zigzagged between its sometimes grandiose desires to implement bold change and the practical constraints of governing. While concrete policy actions in and of themselves were not particularly damaging, the tension between rhetoric and practice had a high cost since it generated considerable uncertainty, undermined the government,s international image and led to a drop in investment and growth. End summary.

¶2. (C) The Correa administration completed its first year in office on January 15, and this cable examines economic policy-making during that year. A separate cable addresses likely economic policy developments in 2008, when we expect the balance to shift to perhaps more measured rhetoric but an increase in actual policy change, with a net effect of maintaining the uncertain, challenging environment for investors.

-- -
OVERVIEW OF CORREA,S ECONOMIC POLICIES AND PRACTICE
-- -

¶3. (C) In the Correa administration's first year in office, its rhetoric was usually appreciably worse than the economic policies that it actually implemented. In practice, many more policies were discussed or even announced than actually implemented. Of the the latter, most were relatively pragmatic, some were unhelpful, but none were particularly egregious (the 99 percent oil windfall tax, for example, has not actually been imposed and appears on course to be scaled back). A scorecard comparing the Correa administration,s rhetoric and practice in 2007 follows in paragraph 9. The uncertainty generated by this style of economic posturing and policymaking discouraged private investment, and the economy stumbled along in 2007, growing less than two percent even as oil prices increased.

¶4. (C) In practical terms, the GOE did not make many major policy adjustments last year. At the beginning of his administration, Correa raised income and housing transfers to the poor, expanding programs that were already in place. Additional control over the banking sector, the first major policy change that the GOE attempted in 2007, was watered-down by Congress. Another notable development was a decree requiring oil companies to share 99% of windfall oil

income with the state, but in practice that has been on hold as the GOE seeks to renegotiate contracts. The GOE planned to increase investment spending, but implementation was slow in 2007. At the very end of 2007, the GOE secured approval for an overhaul of the tax code, which was a mix of the practical and unhelpful. As inflation increased, the GOE imposed a limited number of price restrictions. In other areas, there has been lots of talk and some planning, but limited change.

TREATMENT OF U.S. INVESTORS

¶5. (SBU) The Correa administration's treatment of U.S. companies parallels this mixed picture. All of the notable bilateral investment disputes predate the Correa administration, and the Correa administration is in fact addressing the problems on various arbitration or negotiating tracks, although at times the rhetoric may have implied or initially threatened otherwise.

¶6. (SBU) The Correa administration has criticized international arbitration, particularly the World Bank,s ICSID forum, but has committed to participate in arbitration cases brought by two U.S. oil companies, Occidental and City Oriente. The GOE has also committed in writing to pay an arbitration award for an earlier Occidental arbitration case. Correa criticized City Oriente for its decision not to pay a 2006 oil income windfall tax, which led some GOE officials to initiate threatening actions against City Oriente. However, those actions have been reined in and the GOE is now attempting to renegotiate City Oriente,s contract.

¶7. (SBU) The situation for Machala Power, a U.S. electricity company, remains essentially unchanged from the prior administration: the GOE acknowledges it needs to clear payment arrears but has not developed a plan to do so. Meanwhile, the Correa government is largely current on recent payments to Machala Power.

¶8. (SBU) U.S. companies outside the energy sector have not had significant problems but do have broader concerns about Ecuador's challenging investment environment: some are looking to divest because of the uncertainty, some (cars, cigarettes) may see sales fall because of higher excise taxes, some are concerned with higher labor costs, others are concerned that they might be subject to price controls, and the one U.S.-owned bank is watching the changes to banking regulations with care.

2007 REVIEW

¶9. (C) 2007 Scorecard on economic rhetoric and actual implementation:

Macro/Social

Upshot: Increased spending, slower growth, no macro plans, capital outflow tax.

Rhetoric: Attributed current problems to past administrations and failed policies, prioritized correcting policies before focusing on growth. Criticized dollarization in principle, but pledged to retain it while in office. Called for policies to support small businesses and improve education, health and social services.

Practice: Paid little attention to macro/growth issues and has not articulated a broad macroeconomic framework. Maintained dollarization. Imposed 0.5% tax on capital outflow, notionally to retain more capital in-country. Increased income and housing transfers to the poor, but not dramatically, given capacity restraints of the government,s delivery mechanisms. Increased spending and programs for

small businesses and social services, with limited noticeable impact. Increased income and housing transfers to the poor.

Fiscal/Infrastructure

Upshot: Investment plans, but little implementation; higher current spending.

Rhetoric: Asserted increased spending necessary to offset previously insufficient spending in social services and infrastructure. In campaign, promised to lower value added tax (VAT).

Practice: Increased government spending sharply, primarily on current spending. Maintained public sector surplus, thanks to high oil prices. Retained VAT at 12%, imposed a number of other tax changes, some with redistributive intent, some to combat tax evasion. Declared numerous emergencies to use petroleum reserve funds for infrastructure, education, health. Investment spending lagged because of inability to execute projects. Initially sought to implement via public entities (e.g., Corps of Engineers for roads), but increasingly accepting private sector engineering firms. Initiated several large hydroelectric projects in early 2008.

Relations with Business Sector

Upshot: Poor but improving.

Rhetoric: Criticized private sector in general, with specific criticism of larger associations and certain industries, individuals and companies. Promoted GOE plans to invigorate small businesses.

Practice: At the start of the administration allowed almost no contact with the private sector. Still distance between the two, but GOE has increased dialogue with certain sectors over time; private sector influence varies between having input (banking) to being informed of conditions (milk price controls). The big business chambers have little access or influence and distrust the government. Programs to promote small businesses appear to have little impact.

Petroleum/Mining

Upshot: Revenue sharing requirement pressuring companies to renegotiate.

Rhetoric: Called for greater state share of natural resources, but without much specificity.

Practice: Issued a decree requiring many foreign oil companies to turn over 99 percent of extraordinary income to the government. Subsequently sought to renegotiate contracts on mutually acceptable terms; discussions ongoing. New tax law establishes a 70 percent windfall tax on new petroleum and mining contracts. GOE welcomed proposal by U.S./Canadian company to develop heavy oil field for $2-6 billion; discussions ongoing. GOE suspended the concessions for 587 mining concessions that have not paid necessary fees, and might suspend some other concessions. GOE plans to revise mining law but has not revealed details; news reports suggest might require contract restructuring.

Banking Sector

Upshot: Moderate increase in controls over banks.

Rhetoric: Accused banks of high profits; called for lower interest rates and repatriating offshore assets.

Practice: Initially sought strong controls over banking sector, but Congress approved more limited controls.

Eliminated commissions. Interest cap rules in new law subsequently ruled unconstitutional, and Central Bank imposed reasonable alternative interest rate limits. Bank deposits and loans grew in 2007, but at slower rate than prior years.

BITS/International Arbitration

Upshot: BITs remain, GOE participating in arbitration.

Rhetoric: Announced would terminate U.S. BIT after 10-year period expired; chafes at concept of accepting international arbitration; criticized ICSID as favoring investors.

Practice: U.S. BIT remains in force. In January 2008 announced intent to terminate BITs on mutually agreeable terms with nine countries with little investment in Ecuador. Intends to renegotiate BITs with major investors, including U.S., but no plans on how to proceed. Ecuador notified it would not accept ICSID jurisdiction over petroleum/mining cases in the future; MFA officials believe this notification will not constrain investors covered by BITs. GOE participating in several ongoing arbitration cases (Oxy, City Oriente), and declared (privately) that it will honor the Oxy VAT arbitration award. Ceased its assertions that ICSID favors investors. Is exploring creation of regional arbitration body in UNASUR discussions.

Trade/Economic Relations

Upshot: Seeking FTAs with others, Dialogue with U.S.

Rhetoric: Asserted that it would not sign a free trade agreement with the U.S., arguing Ecuadorian agriculture couldn't compete with U.S. agricultural subsidies.

Practice: FTA talks suspended by U.S. under prior government. No current interest in an FTA with the U.S., but concluding FTA with Chile, pursuing FTAs with the European Union and Canada. Agreed to Economic Dialogue chaired by the State Department and MFA to explore mutually beneficial areas of cooperation, but has not moved to implement the Dialogue. Declined to join ALBA.

Debt

Upshot: Honoring its debt.

Rhetoric: Suggested might default on "illegitimate" debt; said would only pay after meeting social obligations.

Practice: Fully paid all debt obligations. Restructured domestic debt, extending maturities, with assistance from

Andean Development Corporation. Debt/GDP ratio and debt servicing as share of budget fell in 2007. Established a debt commission to review debt; no indication of its timeframe or direction it will take.

International Financial Institutions/Assistance
--- --

Upshot: Working with IDB, CAF.

Rhetoric: Criticized World Bank and IMF, usually for imposing unnecessary debt and inappropriate policies.

Practice: Expelled World Bank representative (for personal reasons). After slow start, expanded programs with IDB and CAF. More distant relations with IMF and World Bank, but accepted IMF review mission. Has not accepted Venezuelan financing, favoring better terms of IFI financing. Has crude-petroleum-for-derivatives swap arrangement with Venezuela. Good relations on U.S. assistance programs. Supports Banco del Sur. PDVSA and Petroecuador have cooperation agreement, but primary results to date are

several studies.

Market Intervention

Upshot: Market intervention in three sectors.

Rhetoric: Limited; comments about market speculation appear to follow market intervention decisions. New Minister of Agriculture stated he prefers dialogue over price/export controls.

Practice: Limited market intervention. Has successively used subsidies/government suasion to limit flour prices, imposed rice export ban, and imposed milk price controls. Has sought to limit interest rates, but established caps based on market rates. Has maintained subsidy programs for petroleum derivatives established in prior governments; program has become increasingly costly.

Regional Integration

Upshot: Working on some initiatives, rejected others.

Rhetoric: Promoted regional integration for numerous issues, including suggesting eventual regional currency to replace the dollar.

Practice: Supported some regional initiatives such as Banco del Sur; declined to be part of others, such as ALBA. Seeking own initiatives, such as regional arbitration body. Seeking to promote the Manta-Manaus transportation corridor. Continues to work with Andean Community; urged Venezuela to return to the Andean Community.

-- ----
AN EFFORT TO EXPLAIN THE INCONSISTENCY BETWEEN RHETORIC AND PRACTICE
-- ----

¶10. (C) The Correa administration, largely staffed by academics, brought its own ideological orientation when it took office. This included a strong distrust of economic elites and beliefs that the State should play a more active role in guiding the economy, that certain rules and practices need to be changed, and that some international economic institutions are not in Ecuador's interests. Correa also took office with strong ideas of what he did not like, but with fewer clear ideas of how to address those problems.

¶11. (C) In trying to move forward with its economic vision, the Correa administration was hampered in part by its inexperience in government. A further complication has been Correa's impetuous style, making sudden decisions or announcements without coordinating with his economic advisors (this is certainly has been a complication in dealing with the oil companies).

¶12. (C) But beyond the Correa government's particular operating style, it has also been constrained as it has realized the full consequences of its intended actions. As it has attempted to address what it sees as problems (often accompanied by loud rhetoric), its actions have been limited as it realized the practical consequences of making dramatic changes. For example, the Correa administration wants to

lower interest rates, but realized that significantly tighter controls would provoke a banking crisis. It wants a greater share of petroleum revenues for the State, but knows that it needs foreign investment since a highly inefficient Petroecuador is hard pressed to sustain, much less increase, oil production. It resents international arbitration, but realizes those rules are tied to investment and trade benefits which Ecuador needs.

COMMENT

¶13. (C) The Correa government intends to change a number of economic rules to address various economic and social problems. Some of this involves a greater state role in the economy. Sometimes the process has been unattractive, such as the pressure on oil companies to renegotiate their contracts to avoid the debilitating effects of the 99 percent oil revenue windfall tax. We do not know how this exercise will end, but the actual measures implemented in the first year of the Correa administration have been relatively moderate. Overall, economic policy-making would have been less messy, confusing and damaging for investor confidence had the process to arrive at those measures been done in a less rhetorical and more discreet fashion.
JEWELL